Cite as Det. No. 03-0170, 24 WTD 393(2005)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 03-0170
. . .	)	
	)	Registration No. . . .
	)	. . . /Audit No. . . .
	)	. . . /Audit No. . . .
	)	Docket No. . . .

RCW 82.04.290; RCW 82.04.2907: SERVICE INCOME -- ROYALTIES -- INTERNET VENDORS. Income from referring customers to other internet vendors' websites through the use of tabs or links on the taxpayer's internet website and from enhancing the product selection and purchase processes is taxed as service income and not as royalty income.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Mahan, A.L.J. – The taxpayer is a wholly owned subsidiary of an internet vendor. It receives income from providing links or tabs on the principal's internet website that transfer customers to other internet vendors' websites, from advertising the other vendors' products, and from enhancing the product selection and purchase processes. It protests the Department of Revenue's (Department) reclassification of its income from the royalty business and occupation (B&O) tax rate to the service and other activities B&O tax rate. . . . [W]e deny the taxpayer's petition and remand the case for further proceedings.[1]

ISSUE

Should income from referring customers to other internet vendors' websites through the use of tabs or links on the taxpayer's internet website and from enhancing the product selection and purchase processes be taxed as royalty income under RCW 82.04.2907 or as service income under RCW 82.04.290?

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FINDINGS OF FACT

The taxpayer is a wholly owned subsidiary of an internet vendor. It entered into agreements with several other internet vendors, who sell products not sold by the taxpayer's principal. At issue in this case is the B&O tax classification of the income the taxpayer receives under the terms of these agreements.

Typical of these agreements is an Agreement . . . , between the taxpayer and . . . (Vendor). Under the terms of this Agreement, the taxpayer received a set up fee (. . . $. . . for engineering work), an advertising fee (. . . $ . . .for each year of the agreement), an annual fee (. . .$ . . . for the first year and $ . . . for each of the next two years), and, after the first year, a fee for every new customer . . . .

The express goal of the Agreement was to "maximize [the Vendor's] customers and revenues . . . and create a superior customer experience." . . . As stated in equity research completed when the parties entered into the contracts, the Agreement "will enable customers to shop seamlessly between [the taxpayer] and [the Vendor], with equal levels of customer service. Even if only a small percentage of [the taxpayer's] . . . customers seize the link, we believe the tab will be a huge driver of traffic to [the Vendor's] site."

The Agreement was to be implemented in two phases. Under the first phase, the taxpayer created and maintained on its website a "transition page," which contains "hypertext links that will allow users to navigate directly to pages" on the Vendor's website. . . . Under the second phase, certain of the taxpayer's "Site Functionalities" would be implemented so that the taxpayer's customers could search and pay for the Vendor's products while shopping on the taxpayer's website. . . . Site Functionalities on the taxpayer's website that could be used in the purchase process included such things as the ability to add the Vendor's products to a . . . list maintained on the taxpayer's website, to use the taxpayer's cyber-shopping cart for product purchases, and to locate and read product reviews. Although the taxpayer's customers would use the taxpayer's search and checkout processes to locate and purchase the Vendor's products, the Vendor would fill the orders after the taxpayer transmitted the purchase details to the Vendor. The Vendor was to be the exclusive provider of its product line that customers could locate and purchase through the taxpayer's website.

With respect to the taxpayer's technology (defined to include design, content, product files, images, editorial content, and software), trademark, and "Site Functionalities," the taxpayer reserved all right, title, and interest in such property. No title or interest in any such property was licensed "except as expressly set forth . . . ." . . . [T]he taxpayer and the Vendor granted each other non-exclusive and non-transferable licenses to use the technology, trademark, and site functionalities supplied by each party "as is reasonably necessary to perform its obligations under this Agreement." All goodwill arising out of the Vendor's use of the taxpayer's trademark inured solely to the taxpayer's benefit. . . .

[T]he parties agreed to allocate [less than 10]% of the advertising and annual fee payments to advertising services and [more than 90]% to intangible assets. The taxpayer reported [the percentage allocated to intangible assets] as royalty income for federal and state tax purposes.

The Department audited the taxpayer for the February 1, 2000 through December 31, 2000 period (Audit No. . . .) and for the January 1, 2001 through April 30 2002 period (Audit No. . . .). The Department reclassified the royalty income as service income, and issued deficiency assessments of $ . . . and $ . . . , respectively. The taxpayer timely appealed the assessments. . . . .

ANALYSIS

RCW 82.04.220 levies a B&O tax "for the act or privilege of engaging in business activities" in Washington. The tax rate or rates applicable to a particular taxpayer depends upon the type of activity or activities in which it engages, *e.g.*, manufacturing, wholesaling, service, or retailing. Persons subject to the service B&O tax classification include, but are not limited to, "persons engaged in the business of rendering any type of service which does not constitute a 'sale at retail' or a 'sale at wholesale'." RCW 82.04.290. The Department concluded the taxpayer was engaged in providing services subject to tax under RCW 82.04.290. The taxpayer contends that, instead, its income should be classified at the lower royalty rate provided under RCW 82.04.2907.

Income from the activity of licensing or granting the right to use certain intangible property was classified as income from royalties, effective July 1, 1998:

> Upon every person engaging within this state in the business of receiving income from royalties or charges in the nature of royalties for the granting of intangible rights, such as copyrights, licenses, patents, or franchise fees, the amount of tax with respect to such business shall be equal to the gross income from royalties or charges in the nature of royalties from the business multiplied by the rate of 0.484 percent.
>
> "Royalties" means compensation for the use of intangible property, such as copyrights, patents, licenses, franchises, trademarks, trade names, and similar items. It does not include compensation for any natural resource.

RCW 82.04.2907.

Both the taxpayer and the Department recognize that the contract at issue involved aspects of both service and the granting of the use of intangible property. The taxpayer contends that the primary business activity was the granting of the use of intangible property. Further, the taxpayer contends the contract is not subject to bifurcation, other than the [more than 90]%/[less than 10]% allocation provided under the terms of the contract.

While we agree the contract does not provide a basis to bifurcate the amount characterized in the contract as royalties (*see, e.g.*, Det. No. 98-012, 17 WTD 247 (1998)), this does not preclude the Department from determining how that income should be classified for B&O tax purposes. In general, with a contract not subject to bifurcation, the Department looks to the "primary activity" (Det. No. 92-183ER, 13 WTD 96 (1993)) or the "predominate nature" (Det. No. 91-163, 11 WTD 203 (1991)) of the activities to determine the B&O tax classification of the income. *See generally* Det. No. 98-012, 17 WTD 247 (1998). The test has also been characterized as a "true object" test. As stated in Det. No. 98-213, 19 WTD 777 (2000):

> When determining whether a retail sale of tangible personal property or some other type of property or service has been purchased, the Department has frequently focused on the "true object" of the transaction sought to determine the proper tax classification. Det. No. 89-009A, 12 WTD 1 (1992) (discount memberships); Det. No. 94-115, 15 WTD 019 (1994) (food demonstrations). See also WAC 458-20-211, ETA 520.04.211, and ETA 573.04.224 . . . . Although the OEM does receive some tangible personal property, i.e. a reproducible master copy, this tangible copy is only incidental to the intangible right to reproduce and re-license the product. It is not the "true object" of the transaction. Instead the "true object" of this transaction is the right to reproduce and distribute copies of Taxpayer's computer program.

As we have stated, the inquiry as to the true object of a transaction "should focus on what the buyer is seeking in exchange for the amount paid to the seller. *See Hellerstein, Significant Sales and Use Tax Developments During the Past Half Century*, 39 Vand. L. Rev. 961, 970 (1986)." Det. No. 94-115, 15 WTD 19 (1995).

In determining what the Vendor sought in exchange for the payments, we first note the vendor did purchase significant services from the taxpayer. An analogy to brick and mortar vendors illustrates the service aspects. Two brick and mortar merchants could reach an agreement similar to the one in the present case. One merchant could agree, for a fee, to refer its customers to the other merchant, advertise the other merchant's products, and provide its customers with a copy of the other merchant's catalog. It could further agree to accept orders and payment from its customers and use its in-store ordering process and customer service for the other merchant's goods. The taxpayer provided each of these services to the Vendor. But we are dealing with e-retailing or cyber-shopping, not a brick and mortar vendor, and technology and intellectual property rights play a more important role.[2] At issue then is whether the services constitute the true object of the agreement or, instead, whether the technology and licensing aspects constitute the true object of the agreement.

[2] Because of the manner in which these services were provided, some aspects could possibly be described as information services, as set forth in WAC 458-20-155. But such services would still be taxable under RCW 82.04.290.

A resolution of this issue requires an understanding of the internet and how the parties used it in this case.[3] The internet is a global network of interconnected computers that allows individuals and organizations around the world to communicate and to share information with one another. *See* RCW 82.04.297. The world wide web, a collection of information resources contained in documents located on individual computers around the world, is the most widely used and fastest-growing part of the Internet except perhaps for electronic mail ("e-mail"). *See United States v. Microsoft*, 147 F.3d 935, 939 (D.C. Cir. 1998). The world wide web is a graphic subnetwork of the internet. RCW 82.04.297.

Prevalent on the world wide web are multimedia websites. A website consists of at least one, and often many, interconnected web pages. The web pages are computer data files written in Hypertext Markup Language (HTML) that contain information such as text, pictures, sounds, and audio and video recordings. The web pages also usually contain connections or hyperlinks to other web pages on the same website and to other websites altogether. In the present case, the taxpayer had on its website hyperlink connections to a "transition page," which then had hyperlinks to the Vendor's website. For customers going to the Vendor's website, there were also hyperlink connections by which the customers could return to the taxpayer's website.

Each website has a corresponding domain name, which is somewhat analogous to a telephone number or street address. *See Panavision Int'l, L.P. v. Toeppen*, 141 F.3d 1316, 1318 (9th Cir. 1998). Upon entering a domain name into a web browser, the corresponding website's "homepage" will appear on the computer screen (*e.g.*, by entering www. . . . .com). A website's domain name signifies its source of origin and is, therefore, an important signal to internet users who are seeking web resources. Companies commonly use a trade name or trademark within the domain name. *See Panavision*, 141 F.3d at 1327. Because of the importance of a domain name in identifying the source of a website, the use of another's trademark within the domain name of a website can constitute a trademark violation. *See, e.g., PACCAR Inc. v. Telescan Tech. LLC*, 319 F.3d 243, 250 (6th Cir. 2003) (citing cases). In providing links between the two websites, an express or implied right to use the other's domain name may have been necessary.

Each web page within a website has a corresponding uniform resource locator ("URL"), which consists of a URL that identifies the homepage and, for subsequent web pages, a post-domain path. A post-domain path shows how a website's data is organized within the host computer's files. In the present case, once a customer uses the hyperlink connection to go to the Vendor's website, the URL, as shown on the web browser, indicates that you are on the Vendor's website, not on the taxpayer's website. When on the Vendor's website, a customer was not buying products offered under the taxpayer's trademark or trade name.

[3] The following discussion of the internet is derived in large part from *Interactive Products Corp., v. A2z Mobile Office Solutions, Inc.*, 2003 U.S. App. LEXIS 6848; 2003 FED App. 0111P (6th Cir. 2003), which credits *Brookfield Communications Inc. v. West Coast Entertainment Corp.*, 174 F.3d 1036 (9th Cir. 1999), and *Patmont Motor Werks, Inc. v. Gateway Marine, Inc.*, 1997 U.S. Dist. LEXIS 20877, No. C96-2703, 1997 WL 811770 (N.D. Cal. Dec. 18, 1997), for its discussion of the internet.

Search engines are often used to locate products or resources on the internet. Each search engine uses its own algorithm to search for and arrange responses to the search request, so the list that any particular set of keywords will bring up may differ depending on the search engine used. *See Niton Corp. v. Radiation Monitoring Devices, Inc.*, 27 F. Supp. 2d 102, 104 (D. Mass. 1998). In the present case, the taxpayer's website utilizes a search engine that allows customers to search among the products it sells. Under the terms of the Agreement, the search engine also could be used to search for products offered by the Vendor. But once a customer used the hyperlink connection to go to the Vendor's website, product searches would be performed by the Vendor's search engine, not by the taxpayer's search engine.

As discussed above, the Agreement also provided for various taxpayer-specific functionalities. Some of these fucntionalities may be subject to patent or other intellectual property protections. . . . The functionalities were available on the taxpayer's website for its customers to use. But the functionalities were not available to the Vendor's customers operating from the Vendor's website.

Overall, the licensing of technology and intellectual property rights in the present case appears to be limited in nature. For example, the licensing of intellectual property rights with respect to the creation and use of the tabs or hyperlinks involved the use of domain names and trademarks. But the Vendor was not licensed to do business under the taxpayer's trademarks of trade name. With respect to the taxpayer's site functionalities, the taxpayer created and maintained those functions on its website, and those functionalities involved protected intangible rights. But the taxpayer was the one that used its own functionalities in providing the services; it did not license those functionalities to the Vendor for use on the Vendor's website. Similarly, with respect to the search engine, the taxpayer provides its customers with the ability to search products available from the Vendor, and that search engine involved protected intangible rights. But the taxpayer is the one that used its own search engine in providing the service; it did not license its search engine to the Vendor for use on the Vendor's website.

While the technology and the intangible rights provided the means for the services, for the most part the taxpayer is the one that used the technology and intangible rights. Consistent with the terms of the agreement, any license to use technology or intellectual property was limited to only that which was "reasonably necessary [for the taxpayer] to perform it obligations." Under the facts of this case, we conclude that the intellectual property licensing was limited in nature, and the true object of the contract was the services provided by the taxpayer.

In arguing for the lower royalty rate, the taxpayer analogizes its business activity to income from a franchise fee. But that is not an apt analogy. In its simplest form a franchise right entails a license to sell a product under a trademark. Modern franchise rights commonly include the right to sell a specific product at a specific location through the use of trademarks and proprietary operational procedures designed to insure that products meet uniform quality standards. *See Lobdell v. Sugar 'N Spice, Inc.*, 33 Wn. App. 881, 890, 658 P.2d 1267 (1983); 62B Am. Jur. 2d *Private Franchise Contracts* § 9 (1990). But the core of a franchise lies in the licensing or granting of intellectual property rights, with the license of the trademark being of the greatest importance. D. Gurnick, *A*

symposium on Franchise Law: Intellectual Property in Franchising, 20 Okla, City U. L. Rev 347 – 348 (1995). The present case is neither one where the Vendor is selling products under the taxpayer's trademark nor one where the taxpayer's trademark or other intellectual property was licensed to the Vendor for the Vendor to use in its business operations.

In support of its claim, the taxpayer further contends that the Vendor primarily benefited from the Vendor's association with the taxpayer's "name, trademark, trade name, and URL . . . [its] brand and the enjoyment of the goodwill associated with it." Such association included being prominently labeled . . . on the taxpayer's homepage. But capitalizing on goodwill is different from granting the use of an intangible right, such as may occur on the licensing of the right to sell products under a trademark. This can be illustrated by going back to our analogy to a brick and mortar merchant. The fact that the merchant may be able to charge more for its referral and other services because of the quality of its brand (and the goodwill associated with it), as shown by its high in-store traffic volumes, does not change the activity from service to royalty. The income is from providing services, not the transfer or a right to use intangible goodwill. The fact that the taxpayer in the present case can capitalize on its established goodwill, as shown by the high cyber-store traffic volumes, and charge higher rates for its referral and other services does not imply that its income is derived from royalties.[4]

Accordingly, the income at issue was not primarily from granting the use of "copyrights, patents, licenses, franchises, trademarks, trade names, and similar items" as identified under RCW 82.04.2907, as the taxpayer contends. Although there was a cross-license of certain intellectual property rights, as essential to carry out the purpose of the Agreement, such license was incidental to the services being provided by the taxpayer to the Vendor, and not the true object of the agreement. We sustain the Department's assessments.

DECISION AND DISPOSITION:

We deny the taxpayer's petition for correction of the assessments.

Dated this 21st day of May 2003.

[4] Our conclusion in this regard is consistent with the terms of the Agreement, which provided that all goodwill arising out of the Vendor's use of the taxpayer's trademark inured solely to the taxpayer's benefit.